In The

SUPREME COURT OF THE UNITED STATES

October Term, 1973

No. 73-641

EDWIN A. SNOW and HELEN B. SNOW,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR PETITIONERS

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PRELIMINARY STATEMENT

Petitioners' Reply Brief appears in typed rather than printed form by permission of the Clerk, United States Supreme Court. Permission was granted because Respondent's brief, due March 23, 1974, was not received until 5:00 p.m. on April 4, 1974, in "proof" form, and not until April 8, 1974, in final printed form.

Forty (40) printed copies of this brief will be filed with the Clerk as soon as possible.

REPLY TO RESPONDENT'S STATEMENT

Respondent states, "Thereafter, Trott conceived the idea of a tape recording device and a leaf or trash burner, both of which the Crossbow employees began developing." (Res. Br. 3.) This implies Trott did not conceive the idea until sometime after he acquired an interest in Crossbow. The testimony of Trott, however, is as follows:

> "The identification of what I thought was the problem and the need occurred in late 1963, shortly before I resigned from Procter & Gamble. The idea concerning what to do about that problem, the problem being the disposal of leaves and trash, the first idea what to do about that problem did not occur until 1964. The final, what we hoped would be the final resolution of the problem occurred in 1966."

Trott went on to testify he personally spent at least one-third of his time on the trash burner from 1964 to 1966. (I-A. 50.)

Respondent points out that the Petitioner, in February or March of 1966, orally agreed to join in a limited partnership venture to assist Trott in financing the development of the device. (Res. Br. 4.) Petitioner also testified, however, that he was induced to become a member of the partnership on the strength of his own judgment, confirmed by patent counsel, that Burns had a unique and marketable way of incinerating or burning trash, and, secondly, that there was a considerable market for this kind of equipment and no such piece of equipment was then available on the market. (I-A. 19.) Trott further testified he formed the partnership not only to raise capital but also

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1 "A" references are to the record appendix which is separately bound in two volumes. References to "I" and "II" are to the volume of the record appendix.

to gain the experience of the members of the partnership. (I-A. 76.)

REPLY TO RESPONDENT'S ARGUMENTS

SUMMARY OF ARGUMENT

A

Prior to the enactment of Section 174, there was no specific statutory treatment of research or experimental expenditures. There was considerable uncertainty whether these expenditures were deductible currently or were capital in nature, particularly in those cases involving small businesses with no regular research budget. This treatment at both the administrative level as well as in the courts resulted in discrimination against small businesses in favor of large, well-established businesses, thereby discouraging research by small and beginning businesses and fostering monopoly on the part of large and well-established businesses.

Having recognized this discrimination, Congress sought to alleviate the problem for small business by providing definite rules for the treatment of research and experimental expenses whereby small and large taxpayers would receive uniform treatment. This, said the Senate Finance Committee, would "help small, pioneering businesses." (H.R. 8300, 83d Cong. 2nd Sess. P. 105, April 7, 1954.) To this end, Section 174 of the Internal Revenue Code of 1954 was conceived, and after thorough examination by Congress, it was enacted into law.

Section 174 (a) provides:

> "(a) Treatment as Expenses —
>
> (I) In general — a taxpayer may treat research or experimental expenditures which are paid or incurred

> by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. *The expenditures so treated shall be allowed as a deduction.*" (Emphasis supplied.)

Notwithstanding the enactment of Section 174, the uncertainty which prevailed prior to its enactment has continued at both the administrative and judicial levels of government. The uncertainty is perpetuated largely by a continuing application of standards enunciated within the meaning of Section 162.

B

The issue in this case is whether Burns Investment Company incurred research or experimental expenditures during the taxable year 1966 "in connection with its trade or business" so as to be deductible under Section 174. Both courts below denied the deduction citing as authority cases decided under Section 162 of the Internal Revenue Code of 1954 and its predecessor Section 23 of the Internal Revenue Code of 1939 and earlier Revenue Acts, specifically the Revenue Act of 1928, *Deputy* v. *duPont,* 308 U.S. 488.

Respondent suggests, as did the lower courts, that the expenses here in question fall into the category of "preparatory" or "pre-operating" expenses in preparation for the possibility of entering a new trade or business, again relying on cases decided under Section 162 and its predecessor. Respondent would have us place research and experimental expenditures in the same category as pre-operating expenses which are capital in nature and are never deductible until such time as the project is abandoned or is otherwise disposed of. This construction would render Section 174 useless as an incentive to encourage research and experimental expenditures in the development of new products, execpt for large well-established businesses. *Best*

Universal Lock Co., 45 T.C. 1 (1965) (Acq. C.B. 1966-2, 4). *Revenue Ruling 71-162,* (1971-1 C.B. 97).

The record, however, clearly shows that it is incorrect to categorize the expenses at issue here as "pre-operating." In this case, the general and managing partner (who is also the inventor) had carried the business well beyond the preparatory stage by the time the partnership was formed. He (the inventor) had constructed prototype models, conducted experiments, sought the advice of patent counsel as to patentability and had otherwise investigated the various approaches and was therefore beyond the investigatory, preparatory or pre-operating stage prior to formation of the partnership, Burns Investment Company.

Contrary to Respondent's assertions, (Res. Br. 11.) Petitioner does not acknowledge that his partnership was not engaged in a trade or business nor does he acknowledge that petitioner himself is not engaged in a trade or business. To the contrary, Petitioner argues he considered himself to be in the trade or business of inventing and developing new products by virtue of his activities in the three partnerships. (I-A. 29; I-A. 15.)

Petitioner does not argue, as Respondent contends, that "all Section 174 requires is the existence of a profit motive." (Res. Br. 11.) Petitioner argues, however, that a profit motive is an essential element in finding the existence of a trade or business, and a definite profit motive is clearly present in this case.

The term "trade or business" cannot be read in a vacuum as Respondent urges. Surely there is a different standard intended in Section 162 which uses the phrase "ordinary and necessary expenses incurred in carrying on a trade or business" as compared to the standard used in Section 174, "research and experimental expenditures paid or incurred by him in connection with his trade or business." In dis-

cussing the standard within Section 23 of the Revenue Act of 1928 (the forerunner of Section 162), this court stated: "The standard set up by the statute is not a rule of law; it is rather a way of life." *Welch* v. *Helvering*, 290 U.S. 111. Moreover, those sections of the Code wherein a Section 162 standard is intended are specifically linked together by adopting the term trade or business as used in Section 162. See Regulation 1.513-1(b). Nowhere does Section 174 or the Regulation thereunder cross reference the term "trade or business" as used in that section with the term "trade or business" as used in Section 162. This court should therefore fashion a standard for the benefit of both taxpayers and government that will achieve congressional intent.

C

Respondent contends:

> "Neither the Petitioner nor any other members of the partnership held themselves out as engaging in the activity of selling anything. Indeed, the partnership had nothing whatever to sell because the invention was still in the development stage and did not even function properly. Under these circumstances, the activities of Petitioner and his partnership did not satisfy the elements of the well-established "trade or business" definition. They were at best an investigation into the future marketing or a trash-burning device. . . ."

Respondent's conclusion assumes there are two possibilities, namely: (1) investigatory, pre-operating expenses which do not qualify under a Section 162 standard, and (2) ordinary and necessary expenses incurred in carrying on a trade or business which clearly qualify under Section 162.

Petitioner submits Section 174 was enacted as an exception to Section 162 specifically providing for the deductibility of expenses qualifying as research and experimental expenditures. The strength of the statute should also remove Section 174 from a standard correlating to Section 162, i.e., investigatory, pre-operating.

A review of the development of the judicial doctrine of investigatory, preparatory and pre-operating expenses established by the lower courts will clearly show this was intended to distinguish those expenses meeting the Section 162 standard from those expenses that fall short of that standard.

Petitioner strongly contends Section 174 has its own standard which falls somewhere in between and separate and apart from the investigatory, preparatory and pre-operating standard and the Section 162 standard.

As to the stage of development of the trash burner in January of 1966 or the early part of 1966, the Respondent's witness testified as follows:

> "We had built a number of experimental models prior to that time with varying degrees of success. We had at that time to the best of my recollection a model and pretty clear cut specific ideas about how to bring that model to a state of commercial and practical effectiveness." (I-A. 51.)

> "I don't quite know how to answer there. We had a product on which we could have secured a patent at that time. The product we have now is in some ways essentially different. The product on which we got a patent, applied for a patent in 1969, was no further developed from the standpoint of being a finished manufactured product than the project we had in 1966." (I-A. 66.)

Although the partnership, Burns, did not have a perfected product ready for sale during the taxable year 1966,

it was clearly beyond the investigatory, preparatory stage. As a practical matter, it is impossible for a business to have research and experimental expenditures qualifying under Section 174, within the tests urged upon us by Respondent, during the development of its initial product. The practical result would be to force these research and experimental expenditures into the category of pre-operating expenditures and render them non-deductible and non-depreciable. The only time they would ever be deductible is upon abandonment of the project or where it is otherwise disposed of. This construction leaves Petitioner precisely where he would have been had he incurred the expenses in a year prior to the enactment of Section 174. This interpretation will discourage research and experimentation, stifle the search for new products and frustrate congressional intent.

Petitioner does not agree that, with one possible exception, the Sixth Circuit's Opinion below is consistent with all reported cases under Section 174. The Fourth Circuit Court of Appeals in *Cleveland* v. *Commissioner,* 297 F. 2d 169 (C.A. 4), correctly applied Section 174 and later correctly applied Section 162 in *Richmond Television Corp.* v. *United States,* 345 F.2d 901 (C.A. 4), vacated and remanded *per curiam* on other grounds, 382 U.S. 68, obviously grasping the distinction between the two statutes.

ARGUMENT

BOTH COURTS BELOW ERRED IN HOLDING THE RESEARCH AND EXPERIMENTAL EXPENDITURES AT ISSUE WERE NOT INCURRED IN CONNECTION WITH THE TRADE OR BUSINESS OF BURNS INVESTMENT COMPANY.

A. Introduction: The Background and Scope of Section 174

1. Respondent has covered the development of Section 174 by comparing it to Section 162. In this comparison, Respondent is careful to point out that Section 162 allows a deduction for "all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Respondent has done an excellent job of tracing the development of Section 174 and 162. However, Respondent is unable or unwilling to release Section 174 from the bonds of or nexus of Section 162. Respondent's argument is built around cases employing a Section 162 standard, many of which were decided long before Section 174 was enacted. *Welch* v. *Helvering, supra. Deputy* v. *duPont, supra.* These cases are helpful for purposes of Section 162, however, none of the cases apply to Section 174 and the standard contained therein.

In the process of carving out an exception to what is now Section 162, Congress saw fit to eliminate the standard used in Section 162, "ordinary and necessary in carrying on any trade or business" and substitute therefor a new standard "in connection with his trade or business." The courts below have continued to follow the Section 162 standard with the exception of the Fourth Circuit Court of Appeals. *Cleveland* v. *Commissioner,* 269 F.2d 169 (C.A. 4). That

court has recognized the fine line of distinction existing within the statutes and has accordingly fashioned a standard in harmony with Section 174. Respondent, on the other hand, urges a continuation of the pre-1954 standard, citing a more recent case from the Fourth Circuit. *Richmond Television* v. *United States*, 345 F.2d 901. This case, however, did not mention *Cleveland, supra*, and did not involve Section 174 expenses.

Petitioner agrees with the definition of ordinary and necessary standard as set out in *Commissioner* v. *Tellier*, 383 U.S. 687, as quoted by Respondent. (Res. Br. 14.) Petitioner submits, however, that Respondent avoids an essential question which must be resolved before an adequate standard can be developed that will insure achieving congressional intent in the application of Section 174. That question involves the proper relationship between the Section 162 standard ("carrying on any trade or business") and the standard employed in Section 174 ("in connection with a trade or business.") This facet of the issue is glossed over by Respondent and the courts below.

2. Respondent has compared the Regulations issued by the Commissioner in 1919 under the Revenue Act of 1916 whereby the taxpayer was given the option of either currently deducting or depreciating "expenses in his business for designs, drawings, patterns, models, or work of an experimental nature calculated to result in improvement of his facilities or his product. . . ." Petitioner points out that even those Regulations did not require "the carrying on of a trade or busines," just as Section 174 today does not require the "carrying on of any trade or business." (Res. Br. 16.)

Respondent's contention (Res. Br. 18.) that Section 174 must be viewed in the context of Sections 162 and 263 is

perhaps correct. However, it must be remembered that Section 174 is not dependent upon Sections 162 or 263. Nowhere does Section 174 or the Regulation thereunder incorporate the standards of either Section 162 or 263. To the contrary, Section 174 is an exception to those sections and must therefore remain independent of them if it is to be a meaningful and viable statute.

Respondent has cited *Stanton* v. *Commissioner* 399 F.2d 326 (C.A. 5); *Mayrath* v. *Commissioner*, 357 F.2d 209 (C.A. 5); and *Koons* v. *Commissioner*, 35 T.C. 1092. In *Stanton* v. *Commissioner, supra,* the taxpayer sought to deduct expenditures in connection with the development of an experimental boat which was "storm-proof." The boat never was successfully tested, no letters patent sought, nor did the taxpayer attempt to market it. The court, in holding that the taxpayer was *not* engaged in a trade or business, generally discussed the issue as to what will qualify as a "trade or business" in order to deduct this type of expenditure. The court stated that much depends upon the facts of each case before the bar and that "mere working on inventions during the year in question with no activity of offering them for sale or license would be insufficient to show engagement in an inventing business." The points upon which the court relied in its determination that no trade or business existed are as follows: (1) taxpayer's activities were sporadic and not of sufficient sustained character so as to be deemed as engaging in the trade or business of an inventor or a boatbuilder; (2) he had only built a rowboat prior to the year in question; (3) no attempt was ever made to secure a patent on the hull design nor was a patent attorney ever consulted; (4) the boat was definitely not marketable nor was its feasibility ever proven; (5) the taxpayer admitted he did not expect to earn a profit during the years in question in the case. The court finally con-

cluded that the work which the taxpayer carried out concerning the boat was very similar to a hobby.

The record clearly shows the activities of Petitioner, through the partnership, were of a sustained character from the time the partnership was formed; that he was a member of two other partnerships that had then developed two other products which were held for sale or licensing; that patents, both domestic and foreign, were secured; that the burner's feasibility was ultimately proven by a successful entry into the market place; and that Petitioner entered into the partnership with the good faith expectation of realizing a profit.

In *Mayrath* v. *Commissioner, supra,* the taxpayer constructed an alleged experimental house at a cost of $287,-474.11 for his family's personal use. The court found the expenses incurred by the taxpayer in constructing the personal residence to be a personal living expense within Section 262 of the Internal Revenue Code of 1954. By no stretch of the imagination can this case apply to the instant case.

Neither *Stanton, supra,* or *Mayrath, supra,* are in point with the case at hand and offer little in defining "trade or business" as that term is used in Section 174.

In *Koons, supra,* the Petitioner purchased the rights to an invention which was in its early stages of development and entered into a developmental contract with a laboratory for its completion. All contacts with the research laboratory relating to the development were made by the taxpayer's son who acted for and on behalf of his father. The court found at Page 1101 that:

> "The research and experimentation was no doubt in anticipation of the organizing of a business to make business use of an end product when it reached the point of commercial acceptability. At the time the

> invention was bought by petitioner, however, it was in a preliminary laboratory state, and petitioner entered into the so-called Development Contract in part at least to get the benefiit of research specialists. He went no further than this in 1955, however. It is our view that this activity was preliminary to the coming into existence of a business in the year in question within the meaning of Section 174 (a) (1)."

The facts in the instant case differ substantially from the facts in *Koons*.

The Petitioner did not purchase an existing invention, enter into a Development Contract and appoint an agent to oversee the development. Instead, the Petitioner contributed capital while the inventor contributed all rights to the invention to form a partnership, the purpose of which was to continue the development of the incinerator. Unlike *Koons*, the inventor, Trott, conceived the incinerator device, spent at least one-third of his time on it from 1964 to 1966 when the partnership was formed, and thereafter continued as the general and managing partner. (I-A. 72.) Thereafter, the development of the trash burner was carried on through the partnership, Burns Investment Company, to a successful conclusion.

Respondent contends that "under both Section 162 (a) and Section 174, preparatory expenditures incurred prior to the commencement of the taxpayer holding himself out as engaged in selling activities — the *sine qua non* of a 'trade or business' — are not deductible." (Res. Br. 33.) Petitioner's response to that assertion is simply that Burns was not formed to engage in selling activities. It was formed to develop the incinerator device for the consumer and industrial markets. (I-A. 81) There was certainly a holding out of the partnership as being in the business for which it was formed. For example, the members of the partnership caused the partnership agreement to be filed

with the Clerk of Courts, Hamilton County, Ohio, pursuant to the laws of the State of Ohio. (I-A. 81.) The partnership entered into an agreement with a separate corporation to construct prototype models of the incinerator under the direction and supervision of the general partner and inventor. (I-A. 62.) The partnership held regular meetings during the taxable year 1966 where Petitioner participated in the evaluation of the incinerator device, made recommendations as to design features and explored and made recommendations as to various methods of successfully bringing the incinerator device to the market. (I-A. 70.) In those meetings, possible manufacturers were suggested to the general partner who, as the managing partner, had the authority and responsibility to follow up and negotiate sales and licensing arrangements. The degree of holding one's self out in a business situation is a matter of good business judgment. A prudent businessman who has a new item ready for the commercial market is going to minimize the attendant publicity for fear of having his concept pirated by a competitor. The partnership also applied for and was granted an Employer Identification number, filed Federal Income Tax returns, maintained books and records, maintained bank accounts and contracted with others for goods and services.

In addition, Petitioner's testimony is that various methods of marketing were considered including a licensing to another manufacturer. Actually, the form of marketing finally adopted was having the device manufactured and assembled by another manufacturer. Holding rights to a product for licensing, in this instance, is tantamount to holding one's self out as offering goods and services for sale.

3. Respondent states the court below concluded that neither Petitioner nor the Burns Investment Company

partnership were engaged in a trade or business with respect to the trash-burning device because neither Petitioner nor any other member of the partnership held themselves out as engaged in the activity of selling.

In *W. S. Farish* v. *Commissioner,* 103 F.2d 63 (C.A. 5), the court was faced with deciding a case under Section 23 of the Revenue Act of 1932, which provided for deductions from gross income by an individual for losses "incurred in 'trade or business'; or incurred in any transaction entered into for profit although not connected with the trade or business." In that case, the taxpayer had been in the business of training, breeding and selling polo ponies. During the year in question, the business had been in existence for five years, three years less than the eight years rquired for the breeding, training and development of such a pony. The taxpayer therefore had no sales during the year in question. The losses in question were nevertheless allowed.

The Tax Court's opinion below (Cert. App. 29) relied upon *Deputy* v. *duPont,* 308 U.S. 488, in construing the term "trade or business". That case involved construction of Section 23 (a) of the Revenue Act of 1928, the forerunner of Section 162 of the Internal Revenue Code of 1954. The standard of that section is "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." As pointed out earlier, Section 174 does not embody the same standard. In addition, the court held the expenses did not proximately result from the taxpayer's business, but from the business of the duPont Company. In the instant case, the expenses were those of the partnership which was not in the business of selling products or services, but of developing an incinerator device. (I-A. 14.) Moreover, *Deputy* v. *duPont* held that the activities in question in that case could *never*

amount to a trade or business and thus the case never addressed itself to a question critical to the instant case — when does a trade or business begin?

B. Holding Patentable Product or the Rights to a Product Concept for Sale or Licensing to Others is Tantamount to "Holding One's Self Out to Others as Engaged in the Selling of Goods or Services."

1. Respondent continues to argue that Burns Investment Company as well as Petitioner cannot be in a trade or business without offering the product itself, i.e., the trash burner, for sale. Petitioner submits, however, that holding rights or patents for licensing which would yield royalty income is tantamount to offering goods for sale in the ordinary course of business in much the same fashion as is holding real property for rent, See Headnote No. 2, *Whipple* v. *Commissioner*, 308 U.S. 488 (1963).

Respondent contends that one must hold himself out to others as selling goods or services and points out that Burns had no telephone listing, no sign on the building and no separate facilities for offices. The obvious response to that is there was no need to incur expenses for a telephone, for a sign or separate office facilities. Burns Investment Company has none of those things today and yet it is unquestionably carrying on business. (II-A. 169.)

As Respondent points out, *Higgins* v. *Commissioner*, 312 U.S. 212, holds that the existence of a "trade or business" depends upon the facts of each case as found by the triers of the fact. "Whether such activities constitute a "trade or business" as conceived by Section 23 (a) of the Revenue Act of 1928. . . . is open for determination here unfettered by findings and rulings below except for the weight of the intrinsic authority of all lower court opinions." *Deputy* v. *duPont, supra.*

2. Petitioner in no sense of the word concedes that his partnership was not engaged in a "trade or business."

Petitioner does not contend that the judicial definition of "trade or business" is relevant only with respect to those statutory provisions previously construed by the Courts. Certainly it is relevant to the extent it aids the Court in its analysis. It is Petitioner's position, however, that the phrase "ordinary and necessary expenses incurred in carrying on any trade or business" is a far different standard than the standard that expenses be incurred "in connection with his trade or business."

Respondent maintains that the term "trade or business" has a uniform meaning throughout the Internal Revenue Code. (Res. Br. 29) As authority for this proposition, Respondent cites *Cooper Tire and Rubber Co. Employer Retirement Fund* v. *Commissioner,* 36 T.C. 96, affirmed *per curiam,* 306 F. 2d 20 (C.A. 6). In that case the standards of Section 162 were used to decide a case under Section 513. Petitioner points out, however, that this "borrowing" of standards by the court was not done indiscriminately. The Senate Finance Committee Report which introduced Section 513 made explicit reference to Section 23 (a), the predecessor of Section 162. (S. Rept. No. 2375, 81st Cong., 2nd Sess., 1950-2 C. B. 483, 560.) Moreover, the Regulations promulgated under Section 513 make specific reference to "the requirements of Section 162." (I.R.C. Reg. 1. -513-1 (a) (1)) There is no similar cross reference between Section 174 and Section 162, either in the Congressional reports or in the Regulations under Section 174.

Respondent also places great emphasis on *Whipple* v. *Commissioner,* 373 U.S. 193. (Res. Br. 22, 28, 29), as did the Sixth Circuit in its opinion below (Cert. App. 42-44). *Whipple* taught that "investing is not a trade or business" and thus "bad debts arising from activities peculiar to an in-

vestor" are not deductible as business bad debts. *Whipple,* therefore, has no application to the question now before this court, i.e., was Burns Investment Company a "trade or business" within the meaning of Section 174 during the taxable year 1966.

C. At the Time of the Taxable Year in Question (1966), Burns Investment Company Had Advanced Well Beyond the "Investigatory" or "Pre-operating" Stage.

1. Respondent contends that the period of time in which preparations are made for the commencement of the business do not constitute engaging in a trade or business. (Res. Br. 31) Respondent first complicates the problem by imposing section 162 standards and then proceeds to oversimplify the solution by concluding that Petitioner fails to meet the Section 162 standards. Petitioner submits there is an existing body of law defining Section 162 standards which should remain intact, and that a Section 174 standard should be fashioned for Section 174 cases.

Petitioner contends there are perhaps three stages involved in the normal business venture, namely: (1) the preparatory or investigatory stage, (2) the pre-operating stage, and (3) the carrying on stage, i.e., commercial intercourse.

In the investigatory stage, there is no activity except the analysis or evaluation of a given business. The taxpayer may be investigating the potentiality by way of a feasibility study, a market survey or cost study or by traveling to the business sites. In this stage, the taxpayer is not yet engaged in a trade or business. Upon completion of the investigation a decision is made to enter into the business or abandon it. Expenses that fall into this category are clearly not ordinary and necessary business expenses within

the meaning of Section 162. *Morton Frank* v. *Commissioner*, 20 T.C. 511 (1953).

In the second stage, assuming the taxpayer has made the decision to go forward, the trade or business is formed. The vehicle for carrying out the venture is organized; the books and records are established. All of the elements are present in that the business nexus is formed except that products or services are not yet offered for sale. Expenses falling into this category may be "in connection with a trade or business," but do not yet meet the standards inherent in "carrying on a trade or business." See *Richmond Television Corp.* v. *United States*, 345 F. 2d 901; *Henry G. Owen*, 23 T.C. 377 (1954).

The third and final stage, which is contemplated by Section 162, is the point in time at which the business holds itself out as offering goods or services for sale. *Deputy* v. *duPont, supra.* This is the stage at which the business is being "carried on" as required by Section 162.

Petitioner contends in view of the nature of the expense sought to be deducted, he should not be held to a Section 162 standard which is admittedly more rigorous than the Section 174 standard. It is submitted that a Section 174 standard should be fashioned which would allow deductibility for those expenses which properly fall into stage two above, i.e., after the trade or business has been formed, but prior to the time it reaches full maturity, as evidenced by some type of selling activity.

In Respondent's discussion of pre-operating expenses, the followng example is cited:

> ". . . the opening of an office by a young lawyer and his holding himself out as ready to perform the services of his profession would presumably constitute engaging in a trade or business even though he may not receive any fees for a substantial period of time. The costs incurred for overhead during this period

would be deductible as trade or business expenses. However, the pre-operating expenses borne by the young lawyer in deciding where to locate his office would not be deductible." (Res. Br. 31-2.)

If that is a valid premise, then a partnership holding a patentable product or other rights to a product for sale or licensing which would yield royalty income is engaged in a trade or business to the same extent the young lawyer is engaged in a trade or business. This is precisely the status of Burns Investment Company during the taxable year 1966.

There are many classifications within the Internal Revenue Code of expenses that are held to a less rigorous test than that required by Section 162 for purposes of current deductibility. For example, interest paid during the construction period of an apartment project, or other building project may be deducted currently. (Section 163) Soil and conservation expenditures may be deducted currently without regard to when the actual "carrying on" of the farming business commences. (Section 175) Intangible drilling costs may be deducted currently without regard to when the taxpayer commences to realize income from sales or has a saleable product. (Section 263)

The Respondent finally concludes that the activities of the Petitioner and his partnership were at most an investigation into the future possibility of marketing a trash-burning device. (Res. Br. 35) The Petitioner submits the investigatory stage was complete prior to formation of the partnership. The total purpose and function of the partnership was defined as "the development of a special-purpose incinerator for the industrial and consumer markets." (I. A. 81) The investigation has been done by Trott and Snow. (I. A. 19) This is clearly shown by the fact that Trott had received reports from patent counsel in De-

cember of 1965 advising that the incinerator device was patentable, (I. A. 98, 99, 100, 101) and by the numerous and sustained activities which the partnership had undertaken. Respondent's position in this case is that all of this activity is meaningless because of the lack of one item — sales. Such a position puts a new company in a manifestly unjust position. The company will be forced to choose between the following two alternatives:

(1) qualifying for Section 174 deductions by rushing an unfinished product into the market place; or

(2) following the much sounder approach of waiting until the product is fully developed and tested, and then paying for this prudence by being denied the availablity of Section 174.

Surely this type of dilemma is not what Congress intended when it enacted Section 174, which was intended to be "particularly valuable to small and growing businesses."

CONCLUSION

Petitioner submits that he, through the partnership, Burns Investment Company, incurred expenses for research and experimental purposes "in connection with his trade or business" within the proper meaning of Section 174.

Respectfully submitted,

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